adjustments for projected inflation. The 1986 budget resolution specified zero real growth for defense appropriations in 1986 and 3 percent real growth thereafter. Actual 1986 defense appropriations, however, fell short of the budget resolution target, and the 1986 sequestration will reduce the amount of new budget authority even further, to below the 1985 level. CBO's latest baseline projections assume zero real growth in defense appropriations from the 1986 post-sequestration level. Because the Balanced Budget Act lowered the outyear deficit targets contained in the 1986 budget resolution, the assumptions of the resolution can no longer be taken as necessarily representing current Congressional policy. The combination of these factors reduces projected defense outlays by $250 billion for 1986 through 1990 compared with CBO's baseline projections of last August.

Even with 3 percent real growth in defense appropriations in 1987 and beyond, baseline deficits would decline over the next five years, although not as sharply. Instead of baseline deficits declining from $208 billion in 1986 to $104 billion in 1991, they would decline to $150 billion.

SUMMARY TABLE 3. CHANGES IN CBO BASELINE DEFICIT PROJECTIONS SINCE AUGUST 1985
(By fiscal year, in billions of dollars)

Major Changes	1986	1987	1988	1989	1990
August 1985 Baseline Deficit	212	229	243	264	285
Major Changes:					
Lower defense outlays	-9	-26	-48	-71	-96
Lower nondefense discretionary program outlays	-10	-19	-20	-21	-22
Lower net interest costs	a/	-7	-16	-31	-51
Other outlay changes	6	-4	-4	-8	-12
Lower revenues	9	9	10	11	16
Total changes	-4	-48	-78	-120	-165
February 1986 Baseline Deficit	208	181	165	144	120

SOURCE: Congressional Budget Office.

a. Less than $500 million.

The latest baseline projections for nondefense discretionary programs are also lower than those made last year, reflecting reductions made in 1986 appropriations and the effects of the 1986 sequestration. The reduction from CBO's baseline projections of last August is almost $92 billion for the five-year period 1986-1990.

CBO's latest short-term forecast and long-run economic assumptions also feature lower interest rates than assumed last year. These lower rates, together with a reduction in debt service costs because of other changes, reduce net interest outlays by over $100 billion for 1986-1990 compared with last August's baseline projections. Relatively small changes in baseline deficits result from revised projections for farm price supports and Medicare and other entitlement programs, and from slightly lower projected revenues.

Alternative Projections

To show how changes in economic assumptions can affect budget outcomes, CBO has prepared two alternative sets of projections (see Summary Table 4). They are intended to illustrate what could happen if economic growth turns out to be higher or lower than projected over the next six years.

The high path assumes growth almost equal to that of the strongest nine-year expansion of the postwar period, which occurred after the recession of 1957-1958. Because the pace of economic expansion up to now has been close to that in an average recovery pattern, this path implies unusually strong growth from now through 1991. As a result, unemployment falls to 4.6 percent in 1991, while the inflation rate more than doubles. Interest rates also rise sharply after 1988, paralleling the higher inflation rate.

The low path incorporates a recession starting in 1987, which has the depth and duration of the 1973-1975 recession, and is followed by an average economic recovery. The weaker growth results in lower inflation and lower interest rates than in the CBO economic assumptions after 1987, and higher unemployment rates.

Under the high-growth economic assumptions, the deficit drops swiftly to near balance by 1990 and a sizable surplus in 1991. Under the low-growth assumptions, however, the deficit grows sharply. For example, in fiscal year 1989, the year following the recession incorporated in the low-growth path, the deficit is more than $125 billion above the CBO baseline projection.

AUTOMATIC SPENDING REDUCTIONS

If the Congress fails to reduce the 1987 deficit to $144 billion before the start of the fiscal year, an automatic procedure could be invoked that would make the reduction by sequestering budgetary resources. Under CBO's February assumptions, a 1987 sequestration would reduce total outlays to $989 billion--$37 billion below the baseline projection. As shown in Summary Table 5, there would be almost no growth in total outlays beyond the 1986 estimated level of $986 billion.

SUMMARY TABLE 4. ALTERNATIVE ECONOMIC AND BUDGET PROJECTIONS

	1986	1987	1988	1989	1990	1991
Economic Projections (By calendar year)						
Real GNP (percent change)						
High-growth alternative	4.0	4.3	4.4	4.6	4.6	4.6
Baseline	3.2	3.1	3.3	3.5	3.5	3.2
Low-growth alternative	3.0	-0.7	-0.8	5.4	3.4	3.2
CPI-W (percent change)						
High-growth alternative	3.4	4.3	5.2	6.3	7.5	9.1
Baseline	3.4	4.2	4.4	4.4	4.3	4.3
Low-growth alternative	3.6	4.4	3.9	3.0	2.5	2.5
Civilian Unemployment Rate						
High-growth alternative	6.6	6.3	5.8	5.5	5.1	4.6
Baseline	6.7	6.7	6.5	6.3	6.1	6.0
Low-growth alternative	6.9	8.4	9.9	8.9	8.8	8.7
Three-Month Treasury Bill Rate						
High-growth alternative	6.5	6.1	7.5	8.5	9.7	11.1
Baseline	6.8	6.7	6.4	6.1	5.7	5.4
Low-growth alternative	7.6	7.7	5.9	5.6	4.9	4.3
Budget Projections (By fiscal year, in billions of dollars)						
Deficit (-) or Surplus						
High-growth alternative	-202	-154	-111	-61	-1	70
Baseline	-208	-181	-165	-144	-120	-104
Low-growth alternative	-210	-224	-282	-271	-238	-237

SOURCE: Congressional Budget Office.

The sequestration procedures under the Balanced Budget Act for 1987 would begin in August 1986 when CBO and the Office of Management and Budget send their initial budget estimates either to the Comptroller General or to a special joint committee of the Congress. The CBO estimates presented in this report are made for illustrative purposes and are subject to significant revision over the next six months as the result of legislative actions, changes in the economic outlook, and other factors. These estimates show that relying on the sequestration procedures to reach the $144 billion deficit amount for 1987 would mean reductions of $18 billion in outlays for defense programs and $17 billion for nondefense programs from CBO's projected baseline levels, which include the effects of the 1986

SUMMARY TABLE 5. EFFECT OF SEQUESTRATIONS ON BUDGET OUTLAYS FOR 1986 AND 1987 (By fiscal year, in billions of dollars)

Category	1986	1987
Defense Programs a/		
Presequester baseline levels	275	293
1986 sequester	269	284
1987 sequester	269	266
Nondefense Programs b/		
Presequester baseline levels	618	639
1986 sequester	612	632
1987 sequester	612	615
Net Interest and Undistributed Offsetting Receipts c/		
Presequester baseline levels	105	111
1986 sequester	104	109
1987 sequester	104	107
Total Outlays		
Presequester baseline levels	998	1,043
1986 sequester	986	1,025
1987 sequester	986	989

SOURCE: Congressional Budget Office.

a. Budget function 050, national defense.
b. Budget functions 150 through 850, and 920.
c. Budget functions 900 and 950.

sequestration. The result would be to hold outlays for both defense and nondefense programs to roughly the same levels as estimated for 1986.

To achieve these outlay reductions, defense appropriations for 1987 would have to be reduced 6.2 percent below 1986 post-sequestration levels, and nondefense discretionary appropriations would have to be cut by 8.4 percent. The reductions in real terms would be even greater because of the loss of any adjustment for inflation in 1987. For defense programs, new budget authority for 1987 would be limited to $271 billion, which is $30 billion below CBO's baseline projection and $49 billion below the Administration's budget request.

CHAPTER I

THE ECONOMIC OUTLOOK

In 1985, the U.S. economy experienced its third full year of recovery and expansion following the recession of 1981-1982. The pace of expansion slowed noticeably, however, compared with the two preceding years. Most forecasters expect growth to pick up again during 1986, in part because of major turnabouts in government policies and in commodity markets that occurred late last year. The Congress passed major legislation to eliminate the federal budget deficit over a six-year period beginning in 1986. This action appears to have contributed to the rally in the bond and stock markets, which carried long-term interest rates to their lowest levels in six years and raised stock prices to record levels. In response to falling U.S. interest rates, as well as to concerted action by governments of major industrialized countries, the international value of the dollar posted its first sustained decline in several years. Finally, late in 1985 the price of oil began to drop sharply. As this report went to press, real oil prices were at levels below those of the mid-1970s.

THE ECONOMIC OUTLOOK

The current Congressional Budget Office (CBO) economic forecast is much like that of last August. The outlook is still for moderate economic growth in 1986 and 1987 of 3 percent to 4 percent annually. CBO also expects inflation to be somewhat lower than it anticipated last August.

The CBO economic projections are composed of two parts: a short-term forecast for the 1986-1987 period, which is contingent on specific fiscal and monetary policies described below; and a set of medium-term projections for the period 1988-1991. It is important to note, however, that the figures for 1988-1991 are not forecasts of probable economic behavior, but rather a projection of how the economy would evolve during that period if it followed historical trends. 1/

1. The Commerce Department has recently released a major benchmark revision of the National Income and Product Accounts. This revision makes a number of conceptual changes, and rebases real spending from 1972 dollars to 1982 dollars (see Box I-1 for a detailed description of the revision and its implications). CBO's economic projection uses the revised figures.

The Short-Term Forecast

CBO's forecast for 1986 and 1987 is based on the following assumptions about economic policy and other developments:

- The budget deficit targets of the Balanced Budget and Emergency Deficit Control Act of 1985 (Public Law 99-177) are assumed to be fully implemented. Although the deficit target is $171.9 billion for fiscal year 1986, the legislation limits the size of the sequestration (automatic spending cut) in fiscal year 1986 to a maximum of $11.7 billion. Since CBO projections show that the deficit would be $220 billion if no cuts were made, the fiscal year 1986 unified budget deficit is assumed to be $208 billion (see Chapter II). The act imposes no cap on sequestration for later years. Consequently, the deficit for fiscal year 1987 is assumed to be at the target of $144 billion.

- The preliminary target ranges announced last July for the levels of the narrower monetary aggregates are assumed to be adjusted upward somewhat to reflect actual experience through late 1985.

- Food prices are expected to increase less than the general price level.

- The international value of the dollar is assumed to continue to decline, though less rapidly than in the last three months.

- The price (refiners' acquisition cost) of imported oil is assumed to fall about 18 percent between the last quarter of 1985 and mid-1986.

Given the assumptions described above, CBO expects real GNP to grow 3.6 percent between the fourth quarters of 1985 and 1986 and 3.0 percent during 1987 (see Table I-1). It also anticipates that the civilian unemployment rate will average 6.7 percent over 1986 and 1987.

The inflation rate (measured by the change in the implicit GNP deflator) is expected to increase from 3.2 percent over the four quarters of 1985 to 3.9 percent during 1986 and 4.1 percent during 1987. The Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W) is forecast to rise 3.5 percent in 1986 and 4.5 percent in 1987.

Interest rates are expected to decline modestly in 1986. Rates on three-month Treasury bills are forecast to fall from 7.5 percent last year to

6.8 percent in 1986 and 6.7 percent in 1987. Rates on 10-year government bonds are expected to fall from 10.6 percent in 1985 to 9.0 percent in 1986 and 8.9 percent in 1987. This implies a flattening of the yield curve and also substantially lower short- and long-term real interest rates than have prevailed so far in the economic recovery.

Several factors underlie the expectation of continued economic growth in 1986 and 1987:

- o The recent decline in long-term interest rates should provide a favorable environment for investment. Residential investment is forecast to exceed 1985 levels. Lower real interest rates and continued underlying strength in consumer demand should also encourage businesses to invest in new plant and equipment, though the rate of growth in business investment is expected to slow in 1986 and later years.

- o Inventories generally do not appear to be excessive after more than a year of reduced rates of inventory accumulation. Moreover, lower interest rates should reduce the costs of holding

TABLE I-1. THE CBO FORECAST FOR 1986 AND 1987 (In percents)

Economic Variable	Actual		Forecast	
	1984	1985	1986	1987
Fourth Quarter to Fourth Quarter				
Nominal GNP a/	9.0	5.8	7.6	7.2
Real GNP a/	4.7	2.5	3.6	3.0
Implicit GNP Deflator a/	4.1	3.2	3.9	4.1
CPI-W	3.6	3.2	3.5	4.5
Calendar-Year Averages				
Civilian Unemployment Rate	7.5	7.2	6.7	6.7
3-Month T-Bill Rate	9.5	7.5	6.8	6.7
10-Year Government Bond Rate	12.4	10.6	9.0	8.9

a. Projected growth rates are assumed to be similar on a prebenchmark and postbenchmark basis.

inventories, leading some forecasters to predict that businesses will increase their inventory stocks.

- The recent decline in the international value of the dollar should lead to an eventual improvement in the trade balance.

- Lower energy prices are expected to increase real incomes, stimulating the growth of consumption and investment.

In 1986, inflation is expected to rise only slightly. Greater price increases in some sectors are largely offset by the weakness in the prices of oil and other commodities, continued excess industrial capacity, and slack in labor markets. But a continuing decline of the dollar, coupled with the possibility that there will be delayed effects of the large increases in the money supply that have occurred over the last year, may put upward pressure on prices in 1987.

Forecasts for real growth and inflation in 1986 and 1987 are highly uncertain, particularly in light of possible further large movements in energy prices and in the dollar. In early February short term oil price futures were below the refiners' acquisition cost assumed in CBO's forecast for mid-1986 by roughly $6 per barrel. Prices remained volatile, however, and market analysts were split as to whether prices might fall further or regain some lost ground. These uncertainties are discussed further in the sections below.

The Medium-Term Economic Projections

CBO's projections for 1988 through 1991, shown in Tables I-2 and I-3, are not forecasts of economic performance, nor are they necessarily exactly consistent with future economic policies. Instead, they show what the economy's course would be if it were to follow longer-term historical trends in real growth. Nine years separate the most recent recession trough from the last quarter of 1991. On average, since World War II, the annual growth rate of real GNP over such nine-year periods has been 3.7 percent. The CBO projection closely approximates this result.

Such nine-year periods have usually contained at least one new recession, and the current projections allow for a mild downturn. Because of the great uncertainty regarding the timing of business cycles, however, CBO has made no attempt to forecast when that downturn might occur. Instead, the growth rate has been smoothed in the projections so that it averages about 3.5 percent per year from 1988 through 1990. After that, growth slows as the unemployment rate approaches levels at which many economists would expect labor markets to tighten.

The projections show inflation (measured by the implicit GNP deflator) averaging slightly above 4 percent over the 1988-1991 period. Real interest rates are assumed to decline over those years, a reflection of the assumed effect of lower federal deficits under current law. The projections assume that lower federal deficits may also reduce the need for capital inflows from abroad, which will allow the exchange rate to fall and bring about a long-run improvement in net exports.

Behavior of the Tax Base. CBO's projections of federal revenues depend in part on how wages, profits, interest payments, and other incomes are projected to behave. The share of wages and salaries in GNP is expected to remain roughly constant through 1991. Underlying this flattening of the recent downward trend is the assumption that real wages, which have been weak for several years, will grow at a rate that approaches the rate of growth of productivity. The share of nonwage income (proprietors' income, rental income, personal dividend and interest income) in GNP is assumed to fall, primarily because lower interest rates and a lower federal deficit reduce personal interest income. The share of profits in GNP is increased by the reduction in corporate interest expense, and by an assumed slower growth in employer contributions for health insurance and for pension funds. 2/

Sources of Uncertainty. Medium-term projections are necessarily quite uncertain. CBO's projections assume that there will be no major positive or negative supply shocks after 1987, such as those that might result from massive oil price changes in either direction or large crop surpluses or crop failures. The projections also include assumptions about labor force participation rates that have proved quite unreliable in the past. Moreover, for reasons not fully understood, the growth rate of labor productivity has been below average since the late 1970s. The CBO projection assumes that the relation between real growth and worker hours will approximate the postwar experience, and thus incorporates some improvement in this area. There is a risk, however, that productivity growth will follow its more recent trend rather than the higher path that CBO assumes.

The performance of the economy over the medium term will also depend on the policies pursued by the Federal Reserve, as well as on domestic fiscal policy and its repercussions. If, for example, the Federal Reserve were to follow a policy of gradually reducing the annual growth rate of the money supply, it could cause the growth rate of nominal GNP

2. Recent Internal Revenue Service regulations permitting "cafeteria" benefit plans are not reflected in the economic projections, but are incorporated in the revenue projections described in Chapter II.

TABLE I-2. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1988-1991

Economic Variable	Actual	Forecast		Projected			
	1985	1986	1987	1988	1989	1990	1991
GNP (billions of current dollars) a/	3,993	4,269	4,583	4,930	5,313	5,725	6,152
Nominal GNP Growth (percent change) a/	5.8	6.9	7.3	7.6	7.8	7.8	7.5
Real GNP Growth (percent change) a/	2.3	3.2	3.1	3.3	3.5	3.5	3.2
Implicit GNP Deflator (percent change) a/	3.3	3.6	4.1	4.1	4.1	4.1	4.1
CPI-W (percent change)	3.5	3.4	4.2	4.4	4.4	4.3	4.3
Civilian Unemployment Rate (percent)	7.2	6.7	6.7	6.5	6.3	6.1	6.0
Three-Month Treasury Bill Rate (percent)	7.5	6.8	6.7	6.4	6.1	5.7	5.4
Ten-year Government Bond Rate (percent)	10.6	9.0	8.9	8.2	7.5	6.8	6.1
Corporate Profits (percent of GNP)	7.5	8.1	8.1	8.2	8.2	8.1	7.9
Wage and Salary Disbursements (percent of GNP)	49.1	49.1	49.1	49.0	48.8	48.8	48.9
Other Taxable Income (percent of GNP)	19.8	19.3	19.2	19.1	19.0	18.9	18.8

SOURCE: Congressional Budget Office.

a. Projected growth rates are assumed to be similar on a prebenchmark and postbenchmark basis, starting with the first quarter of 1986.

TABLE I-3. MEDIUM-TERM ECONOMIC PROJECTIONS FOR FISCAL YEARS 1988-1991

Economic Variable	Actual 1985	Forecast 1986	Forecast 1987	Projected 1988	Projected 1989	Projected 1990	Projected 1991
GNP (billions of current dollars) a/	3,937	4,192	4,504	4,838	5,214	5,619	6,047
Nominal GNP Growth (percent change) a/	6.5	6.5	7.4	7.4	7.8	7.8	7.6
Real GNP Growth (percent change) a/	2.9	3.0	3.3	3.2	3.5	3.5	3.4
Implicit GNP Deflator (percent change) a/	3.6	3.4	4.0	4.1	4.1	4.1	4.1
CPI-W (percent change)	3.5	3.3	3.9	4.4	4.4	4.3	4.3
Civilian Unemployment Rate (percent)	7.2	6.8	6.7	6.5	6.3	6.2	6.0
Three-Month Treasury Bill Rate (percent)	7.9	6.9	6.7	6.5	6.2	5.8	5.5
Ten-year Government Bond Rate (percent)	11.1	9.2	8.9	8.4	7.7	7.0	6.3
Corporate Profits (percent of GNP)	7.3	7.9	8.2	8.1	8.2	8.1	8.0
Wage and Salary Disbursements (percent of GNP)	49.0	49.1	49.1	49.0	48.9	48.8	48.8
Other Taxable Income (percent of GNP)	20.0	19.4	19.2	19.1	19.0	18.9	18.8

SOURCE: Congressional Budget Office.

a. Projected growth rates are assumed to be similar on a prebenchmark and postbenchmark basis, starting with the first quarter of 1986.

and the rate of inflation to decline in the projection period rather than staying constant, as in CBO's projections. It is uncertain whether such lower nominal GNP growth could be achieved without also reducing that of real GNP below the projected rate.

Finally, achieving the deficit reductions called for in the Balanced Budget and Emergency Deficit Control Act of 1985 will require major changes in federal purchases, transfers, subsidies, and perhaps also taxes. There is great controversy within the economics profession about the impact of such fiscal policy changes, and it is possible that they could make the economy grow more slowly than CBO projects.

Alternative Projections

To show how changes in economic assumptions can affect budget outcomes, CBO has prepared two alternative sets of economic projections that are intended to illustrate what could happen if economic growth turned out to be higher or lower than projected (see Table I-4 and Figure I-1). They should not be seen as limits to the range of likely growth rates, since for a short period economic growth could move outside this range.

The high path assumes that average real GNP growth through 1991 is 1.2 percentage points higher than in CBO's baseline projection. This puts real GNP at the end of 1991 some 49 percent above its value at the recession trough in the final quarter of 1982, the same increase as that experienced in the strongest nine-year expansion of the postwar period, which occurred after the recession of 1957-1958. Because the pace of economic expansion up to now has been close to that in the average recovery pattern, this path implies unusually strong growth from now through 1991. As a result, the unemployment rate falls to 4.6 percent in 1991, well below the level at which most economists would expect inflation to pick up, causing the inflation rate to more than double over the projection period. Interest rates rise sharply higher than in CBO's baseline economic projection after 1988, reflecting both higher inflation and efforts by the monetary authorities to restrain it.

The low path assumes a recession starting in 1987. The recession has approximately the depth and duration of that experienced in 1973-1975, and is followed by an average economic recovery. 3/ The unemployment rate

3. CBO's baseline projections are constructed in a way that does not rule out a minor recession. The low-path alternative differs in that the recession is unusually large, and also that a specific date for the recession is assumed.

TABLE I-4. ALTERNATIVE ECONOMIC PROJECTIONS (By calendar year)

	1986	1987	1988	1989	1990	1991
GNP (billions of dollars) a/						
High	4,305	4,687	5,141	5,706	6,410	7,312
Baseline	4,269	4,583	4,930	5,313	5,725	6,152
Low	4,264	4,424	4,517	4,903	5,179	5,459
Real GNP (percent change) a/						
High	4.0	4.3	4.4	4.6	4.6	4.6
Baseline	3.2	3.1	3.3	3.5	3.5	3.2
Low	3.0	-0.7	-0.8	5.4	3.4	3.2
Implicit Price Deflator (percent change) a/						
High	3.7	4.3	5.0	6.1	7.4	9.1
Baseline	3.6	4.1	4.1	4.1	4.1	4.1
Low	3.7	4.5	2.9	3.0	2.2	2.1
CPI-W (percent change)						
High	3.4	4.3	5.2	6.3	7.5	9.1
Baseline	3.4	4.2	4.4	4.4	4.3	4.3
Low	3.6	4.4	3.9	3.0	2.5	2.5
Unemployment Rate (percent)						
High	6.6	6.3	5.8	5.5	5.1	4.6
Baseline	6.7	6.7	6.5	6.3	6.1	6.0
Low	6.9	8.4	9.9	8.9	8.8	8.7
3-Month Treasury Bill (percent)						
High	6.5	6.1	7.5	8.5	9.7	11.1
Baseline	6.8	6.7	6.4	6.1	5.7	5.4
Low	7.6	7.7	5.9	5.6	4.9	4.3

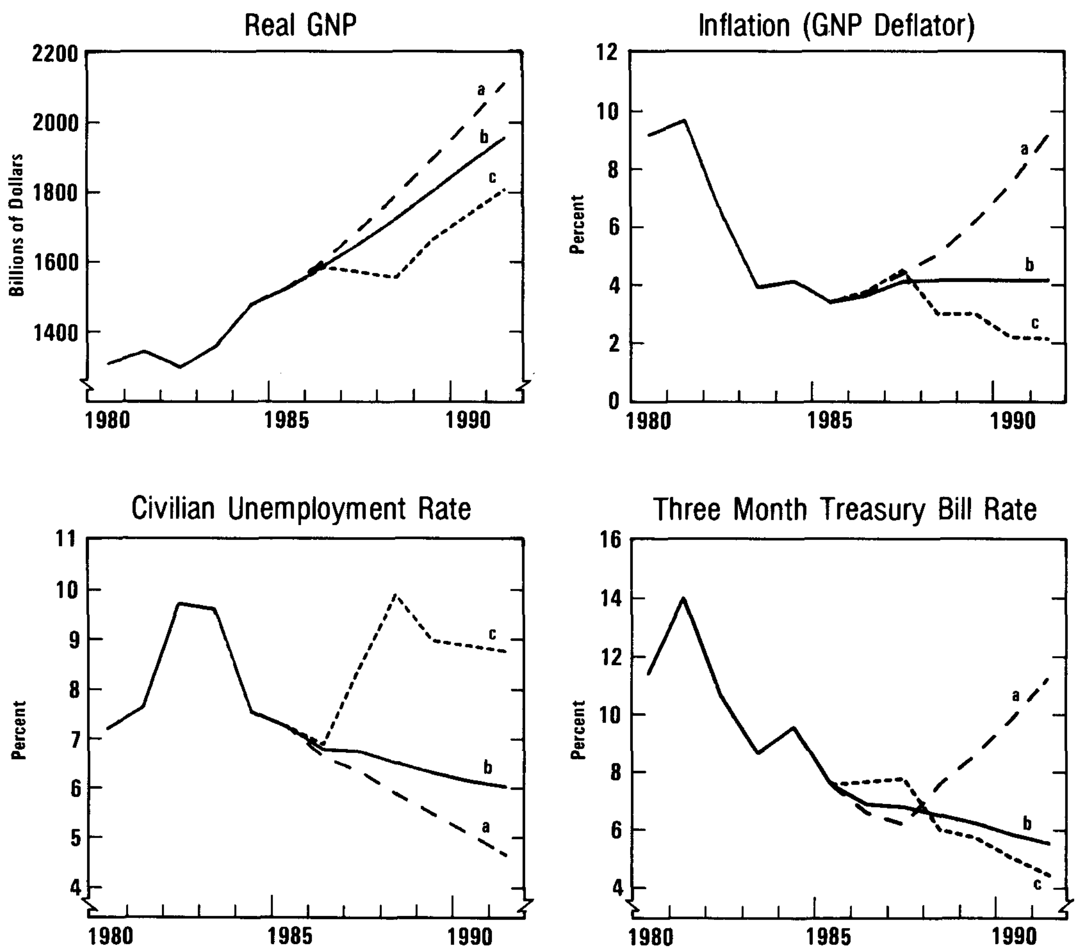
SOURCE: Congressional Budget Office.

a. Projected growth rates are assumed to be similar on a prebenchmark and postbenchmark basis, starting with the first quarter of 1986.

rises to 9.9 percent in 1988 and remains at 8.7 percent in 1991. The inflation rate, which is assumed to rise slightly above its baseline level just before the recession, drops to 2.1 percent in 1991. Interest rates are assumed to remain high during most of the recession, but to drop afterward, reflecting the lower inflation rate. After adjusting the three-month Treasury bill rate for inflation, however, the resulting real interest rate is still almost a full percentage point above its baseline value.

Figure I-1.

Alternative Economic Assumptions



SOURCES: Congressional Budget Office; U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

a High path.

b Baseline.

c Low path.

FISCAL AND MONETARY POLICY

The federal deficit reached record levels in 1985, and the monetary aggregates grew rapidly. But the prospects for reducing future federal deficits were enhanced by passage of the fiscal year 1986 budget resolution and the Balanced Budget Act. The changed outlook for budget deficits probably contributed to the decline in long-term interest rates that occurred late in the year.

Fiscal Policy

Fiscal policy became highly expansionary during the 1980s, with the federal deficit increasing severalfold to a level of more than $200 billion. Now the outlook is for a shift to substantial restraint beginning next year (see Figure I-2 and Table I-5). Under the Balanced Budget Act, the deficit (including off-budget outlays) is to be reduced from about $208 billion in 1986 to a balanced budget in 1991. The decline in the deficit will be particularly sharp in 1987 when the target deficit is $144 billion, an estimated $64 billion decline from the previous year's level. After that, the target will decline by $36 billion per year. To the extent that discretionary tax increases and spending reductions fail to bring the estimated deficit down to the required level, changes in budget policy will be achieved by sequestration--that is, across-the-board reductions in specified defense and nondefense spending categories. There are provisions in the Balanced Budget Act making it possible for the Congress and the President to suspend sequestration temporarily in the event of a significant economic slowdown or an anticipated recession. 4/

While budget estimates are very sensitive to economic conditions, it appears that achieving the deficit targets would not only balance the budget but would also eventually eliminate the structural (or standardized-employment) deficit (see Table I-5 and Figure I-2). The structural deficit--the total deficit calculated at a constant unemployment rate of 6 percent--is projected to reach a record level of $162 billion in 1986, but to decline steadily thereafter to an approximate balance by 1991. The structural deficit falls from 4.0 percent of standardized GNP to zero over this period.

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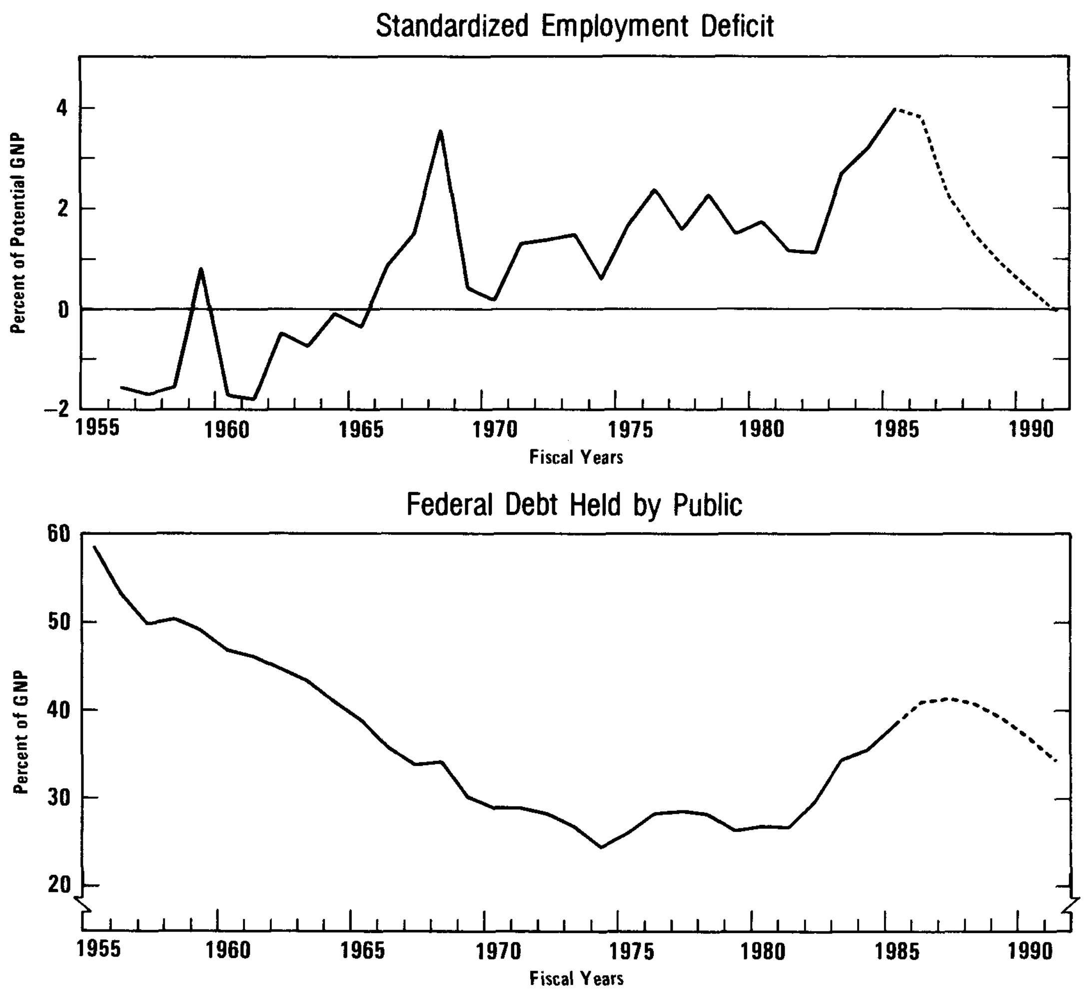
4. The new law and the effect of a recent court decision are discussed in Chapter III.

The new law would also reduce the ratio of the federal debt to GNP--a measure of the burden of the public debt (Figure I-2 and Table I-5). This ratio is projected to begin declining after 1987, the first sustained decline in over a decade. By 1991, the federal debt would drop below 35 percent of GNP, roughly offsetting the increase since 1983 but still substantially above the postwar low of about 25 percent.

Figure I-2.

Measures of Fiscal Policy



SOURCES: Congressional Budget Office; Office of Management and Budget; U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: The values shown for the 1986-1991 fiscal years are based on the assumption that the deficit targets of the Balanced Budget Act will be met.

Long-Run Effects of Deficit Reductions. The gap between net domestic saving and net private domestic investment increased dramatically in the first half of the 1980s, as the rate of net private domestic saving fell while federal deficits soared. The difference was made up by rising net foreign investment in the United States, mirrored in record-breaking deficits in the balance of trade. In February 1985, CBO calculated that, if federal deficits

TABLE I-5. AGGREGATE MEASURES OF FISCAL POLICY (Fiscal years)

Measure	1985	1986	1987	1988	1989	1990	1991
			Billions of Dollars				
Standardized Employment Deficit							
Baseline	161	162	140	128	118	107	103
Balanced-budget target a/	161	162	102	71	46	23	-1
Publicly Held Debt							
Baseline	1,510	1,720	1,900	2,064	2,207	2,326	2,429
Balanced-budget target	1,510	1,720	1,863	1,970	2,041	2,076	2,075
			Percent of GNP				
Standardized Employment Deficit b/							
Baseline	4.0	3.8	3.1	2.7	2.3	1.9	1.7
Balanced-budget target	4.0	3.8	2.3	1.5	0.9	0.4	0.0
Publicly Held Debt c/							
Baseline	38.4	41.0	42.2	42.7	42.3	41.4	40.2
Balanced-budget target	38.4	41.0	41.4	40.7	39.1	36.9	34.3

SOURCE: Congressional Budget Office.

a. Assumes full implementation of the Balanced Budget and Emergency Deficit Control Act of 1985.

b. Percent of standardized GNP.

c. Percent of GNP.

were to average 4.6 percent of GNP over the 1985-1990 period, net foreign investment would have to reach about 2.4 percent of GNP just to sustain a fairly modest level of net private domestic investment of 6.4 percent of GNP. 5/

The deficit targets contained in the Balanced Budget Act radically alter the outlook for savings and investment for the next six years (Table I-6). The deficit is now projected to average 1.9 percent of GNP. As a result, even with the net private domestic saving rate remaining at the relatively low level of the last five years, net private domestic investment could rise to 6.7 percent of GNP, near its 1950-1985 average, requiring net foreign investment in the U.S. of only 0.9 percent of GNP.

Earlier CBO reports and other studies discussed in detail the adverse long-run effects of persistent large deficits. 6/ That analysis implied that the reduction in government dissaving should have the following beneficial effects on the economy.

- o As the deficit shrinks, the federal debt will grow more slowly. Eventually, the debt will decline relative to GNP. A lower federal debt/GNP ratio will allow more room for growth of private debt to finance capital formation, leading to higher productivity. The end result will be higher living standards for future generations than would otherwise be possible.

- o Shrinking federal deficits will make the country less dependent on capital inflows from abroad. To the extent that foreign capital has financed government spending on consumption goods rather than productive investment, this will improve future domestic living standards by reducing debt service obligations to foreigners.

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5. This calculation was based on unrevised NIPA data. It assumed recovery of net private domestic saving to the level of 7.2 percent of GNP prevailing in the 1970s, with state and local surpluses remaining at their high plateau of 1.4 percent of GNP recorded in 1984. The revised NIPA data imply that, because of more net private domestic saving, a slightly higher rate of net private domestic investment could have been achieved with the same deficit figures and smaller net inflows of foreign savings. See *The Economic and Budget Outlook: Fiscal Years 1986-1990* (February 1985), Chapter III, pp. 79-113.

6. See, for example, *The Economic and Budget Outlook: Fiscal Years 1986-1990* (February 1985), Chapter 3, pp. 79-113; and Frederick Ribe and William J. Beeman, *Effects of the Fiscal Monetary Policy Mix on Long-Run Growth in an Open Economy*, forthcoming in the *Papers and Proceedings of the American Economic Association*, May 1986.